COMMONWEALTH OF MASSACHUSETTS
before the
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Fitchburg Gas and Electric Light Company	)	**D.T.E. 99-118**

REPLY BRIEF OF THE ATTORNEY GENERAL

Respectfully submitted,

THOMAS F. REILLY
ATTORNEY GENERAL

By: Alexander J. Cochis
Joseph W. Rogers
Assistant Attorneys General
Regulated Industries Division
Public Protection Bureau
200 Portland Street
Boston, MA 02114
(617) 727-2200

TABLE OF CONTENTS

COMMONWEALTH OF MASSACHUSETTS
before the
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Fitchburg Gas and Electric Light Company	)))	**D.T.E. 99-118**

REPLY BRIEF OF THE ATTORNEY GENERAL

I. INTRODUCTION

Pursuant to the procedural schedule issued by the Hearing Officer, the Attorney General files this Reply Brief for the purpose of responding to arguments made in the Initial and Reply Briefs submitted by Fitchburg Gas & Electric Company ("Fitchburg" or "Company") in this proceeding on June 29, 2001 and July 10, 2001, respectively. This brief is not intended to respond to every argument made or position taken by the Company. Rather, it is intended to respond only to the extent necessary to assist the Department of Telecommunications and Energy's ("Department") deliberations, *i.e.,* to provide further information, to correct misstatements or misinterpretations, or to provide omitted context. Therefore, silence by the Attorney General in regard to any particular argument, assertions of fact, or statement of position in the Company's Initial and Reply Briefs should not be interpreted, construed, or treated as assent, acquiescence or agreement with such argument, assertion or position.

The Attorney General has demonstrated with substantial evidence that the Company's current rates are unreasonably high and should be reduced pursuant to G. L. c. 164, § 93. Fitchburg has not offered any convincing arguments in either its Initial or Reply Briefs to counter the Attorney General's record evidence regarding, *inter alia*, the use of calendar year

1999 as the appropriate test year, the Company's proposal to eliminate completely from the test year all Princeton Paper revenue, the treatment of the Company's depreciation study or the correct approach to determine the inflation adjustment.

II. STANDARD OF REVIEW

Despite the Department's clear guidance on appropriate standards for review in its March 13, 2001 interlocutory order ("Scope Order"), the Company continues to insist that Department treat this complaint case under § 93 in virtually all respects as a rate case under G. L. c. 164, § 94. The Department clearly stated that a "§ 93 earnings investigation is ***not*** a § 94 rate case", although certain aspects of the investigation may "resemble customary rate practice." Scope Order, p. 6 (emphasis added). "[W]hile customary rate case practices may be applicable to an investigation entered into pursuant to § 93, the Department is not bound by the requirements of a § 94 rate case when conducting a § 93 earnings investigation." *Id.*

Despite this clear ruling, the Company continues to insistent woodenly that the § 94 standard of review completely supplant the § 93 standard as detailed by the Department. *See e.g.*, Fitchburg Reply, pp. 4-5. The Attorney General urges the Department to reject the Company's attempt to cast a § 93 earnings investigation as merely a "reverse rate case."

In accord with long-standing state and federal judicial decisions, the Attorney General fully acknowledged and understood that he had the burden to prove his case under the Department interpreted requirements of § 93:

> Although the statute is silent on the topic of which party bears the burden of proof, the Massachusetts Supreme Judicial Court has reasoned while examining § 93 that "the party seeking the benefit of [a rate reduction] has the burden of proving that the existing rate should be changed." *Metropolitan District Commission v. Department of Public Utilities*, 352 Mass. 18, 25 (1967) (citations

> omitted).
>
> ***
>
> Once the Attorney General has shown by substantial evidence the narrow issue of over-earning by the Company, the Attorney General's burden of proof under the statute has been satisfied. Upon a finding of excessive rates, "the Department has considerable discretion as to the implementation of the appropriate remedy", such as an across-the-board rate decrease or the elimination of the revenue surplus through selective rate adjustment. *Fitchburg Gas and Electric Light Company*, D.T.E. 99-118, p. 7 (March 13, 2001) *citing Lynn Gas and Electric Company*, D.P.U. 8390, at 6 (1949); *Millbury Water Company*, D.P.U. 5244, at 2-3 (1936).

Attorney General's Brief, pp. 4-5; *see also e.g.,* Attorney General's Brief, pp. 6, 7 at n. 3, 8, 9 at n. 5, 11 at n. 6, 15, 20, 22, 38.

In its Reply Brief, the Company argues that the Attorney General has failed to meet his burden of proof. It claims that the "Attorney General is misguided in assuming he can prove his case by merely attacking the testimony of FG&E's witnesses, or claiming that FG&E has failed to produce countervailing evidence." Fitchburg Reply, p. 2. Therefore, it requests that Department now "dismiss" the § 93 petition.[1] Fitchburg's Reply Brief, p. 3.

The Attorney General's burden is limited to a showing that "the existing rate should be changed" and this issue is narrow. In December of 1999, the Attorney General submitted that "his five-page complaint established a *prima facie* case that the Company's rates are unjust and

---

[1] As explained fully in the Attorney General's opposition to the Company's still pending motion to dismiss, the production of evidence during a proceeding has nothing to do with whether a case has been appropriately plead in a complaint. The burden on the party moving for dismissal of a complaint is indeed a heavy one. *See Gibbs Ford, Inc. v. United Truck Leasing Corp.*, 399 Mass. 8, 13, 502 N.E.2d 508 (1987). The allegations of the Attorney General's "complaint (and annexed exhibits), as well as such inferences that may be drawn therefrom in the plaintiff's favor, are to be taken as true." *Whitinsville Plaza, Inc. v. Kotseas*, 378 Mass. 85, 87, 390 N.E. 2d 243 (1979) *quoting Nader v. Citron*, 372 Mass. 96, 98, 360 N.E.2d 870 (1977). "In making its determination on whether to grant a motion to dismiss, the Department in reviewing the filing and pleadings must take the facts included in the filing and pleadings as true and viewed most favorably to the non-moving party." *Stow Municipal Light v Hudson*, D.P.U. 93-124-A at 4-5 (1993).

unreasonable." *See* Fitchburg's Motion to Dismiss, p.4. This has been the Attorney General's position since the outset of this case, as expressly recounted by the Company in its January 2001 motion to dismiss.[2] *Id*.

Despite the fact the Attorney General's complaint establishes a *prima facie case* the Attorney General has indeed offered affirmative evidence "as a reasonable mind might accept as adequate to support a conclusion" to demonstrate over-earnings by the Company and the concomitant impact on rates under the standards of § 93. G. L. c. 30A, §§ 1(6) (defining substantial evidence). Through the testimony of Mr. Effron and other record evidence, the Attorney General has not only established that Fitchburg is over earning, but that the Company is over earning by $3.1 million. With the extensive record created in this case, it is now appropriate for the Department to exercise its discretion "as to the implementation of the appropriate remedy", such as an across-the-board decrease in base rates on an equal percent basis.

---

[2] The Company alleges that the Attorney General has taken new positions in his brief regarding *prima facie* evidence that were "announced only after hearings." Fitchburg Reply, p. 2 The Company can not seriously claim in this forum that a five month opportunity to prepare for this issue constitutes unfair surprise of a constitutional nature. Department precedent clearly establishes that all issues concerning the Company rates are at issue. *Bay State Gas Company*, D.P.U. 92-111, p. 6 (1992). Since Fitchburg itself has been a party to the case and had a full and fair opportunity to evaluate the strength of the Attorney General's evidence as it was produced, it is hard to understand how the Company could have been deprived of an opportunity to produce countervailing evidence necessary to rebut the Attorney General's *prima facie* case.

III. ARGUMENT

A. THE DEPARTMENT HAS ESTABLISHED CALENDAR YEAR 1999 AS THE TEST YEAR IN THIS CASE

The Department has already established that 1999 would be the appropriate test year for this proceeding. Scope Order, p. 8. Since the Department decided to base its investigation of Fitchburg's electric distribution rates on calendar year 1999 (Scope Order, p. 8) and in Fitchburg's opinion, there is no difference between the 1999 Test Year with appropriate pro forma adjustments, and 2000 Test year they proposed (Fitchburg Brief, p. 6), a 1999 test year should be used in the investigation of the reasonableness of the distribution rates being charged by Fitchburg.

B. PRINCETON PAPER

The Company proposes to reduce its test year revenues by those associated with Princeton Paper, an industrial customer that stopped taking service during the test year. On brief, the Attorney General demonstrated that the Company's adjustment is inappropriate because:

(1) Princeton Paper's facilities were purchased and "retooled" by another firm - Newark America whose revenues Fitchburg fails to incorporate;

(2) other new large industrial customers have been added to the Company's system since the test year whose revenues were not incorporated; and

(3) the Company's most recent sales forecasts for the rate year and beyond, exceed those of the test year, even with the loss of Princeton Paper.

In response, the Company argues the firm replacing Princeton Paper isn't big enough, so its revenues should be ignored; and the year 2000 sales were down from the test year and therefore, the adjustment is appropriate. The Department should reject both of these argument. Fitchburg is simply trying to omit revenues.

The Department must keep in mind that Fitchburg is proposing to eliminate actual 1999 Princeton Paper revenue in its entirety, without any recognition of revenue from the substantial customer replacing Princeton Paper or revenue from other sources of sales growth since 1999. Indeed, in its reply brief Fitchburg acknowledges that the customer replacing Princeton Paper, Newark America "would be a large customer by FG&E standards," yet takes the inconsistent position that the Department should not recognize that Newark America for the purpose of determining the revenues that will be produced by Fitchburg's present distribution rates. Fitchburg Reply, p. 7. Even if Newark America, by itself, does not entirely replace the Princeton Paper lost revenue, it is completely unreasonable to fail to recognize this "large customer by FG&E standards" for the purpose of calculating pro forma revenues under present rates.[3]

Fitchburg presents a highly selective kWh sales growth analysis to counter the position that the loss of Princeton Paper revenue will be replaced by revenue from other customers. Fitchburg Reply, p. 9. First, Fitchburg states that its sales declined by 6.4% from 1999 to 2000. Although this argument addresses the loss of Princeton Paper sales, it does not consider replacement sales to the new customer, Newark American. This kind of comparison is

[3] Fitchburg obscures the issue by making reference to an analysis supposedly performed by Mr. Effron "to support his revenue adjustment for Princeton Paper." Fitchburg Reply, p. 8. Of course, it is the Company, not Mr. Effron, who is proposing a revenue adjustment for Princeton Paper. Mr. Effron is proposing that there be no adjustment to 1999 test year revenue to remove actual Princeton Paper revenue earned by Fitchburg in 1999. The reason for this position is simple: Mr. Effron is not claiming that Princeton Paper will be a customer in 2002. Rather, based on the evidence presented in this case, it is more likely than not that additional revenue from Newark America, the City of Fitchburg's regional water filtration facility, and other new customers will at least offset the loss of Princeton Paper revenue.

meaningless for the purpose of judging prospective Fitchburg sales during the rate year. In fact, sales to the residential and commercial classes, which are not affected by sales to Princeton Paper or Newark America, increased from 1999 to 2000 (Fitchburg FERC Form 1, p. 304, 1999 and 2000). The testimony by Mr. Collin cited by Fitchburg regarding sales growth in 2001 and subsequent years was entirely unsupported by any factual data. Fitchburg Reply, p. 9. As set forth in the Attorney General's Initial Brief, the best available evidence indicates that sales in 2002, without Princeton Paper as a customer, will be higher than actual sales were in the 1999 test year with Princeton Paper as a customer.[4] Fitchburg Brief, p. 13

Finally, the Company makes arguments that are contradictory and inconsistent. Fitchburg Reply, pp. 10-11. There, with regard to facilities installed to serve Princeton Paper, Fitchburg states:

> The transformer and related service facilities are used and useful in serving the current, smaller customer on the premises, Newark America. Fitchburg has also testified that Newark's operations will be on-going in the rate year, and therefore, the service facilities will continue to be used and useful in the service of Fitchburg's customers.

Fitchburg Reply, pp. 10-11. Thus, Fitchburg is taking the untenable position that direct costs of serving Newark America should be included in the cost of providing electric distribution service, but the revenue from that very same customer should not be included in the determination of revenue produced by distribution rates presently in effect. If the Princeton Paper facilities are included in rate base, then the revenue from Newark America, as well as revenue growth from other new customers, should be included in pro forma test year revenue under present rates. Based on the

[4] The Company's testimony on brief regarding sales and a "slowing economy" are refuted by the fact that most economists are projecting significant growth in the near term. Tr. 2, p. 197.

record in this case, the best way to achieve that internal consistency is to reject the Company's proposed adjustment to eliminate Princeton Paper revenue from the test year. The Company has not refuted the Attorney General's showing that test year sales are reflective of the future.

C. REVENUE ADJUSTMENT FOR YEAR END CUSTOMERS

The Attorney General proposes to adjust the Company's test year revenues to match the sales associated with the year-end number of customers with the Company's test-year end rate base. In its Reply Brief, challenging Mr. Effron's proposal to adjust revenue to reflect the end of year number of customers, Fitchburg states:

> Despite the description provided by the Attorney General on brief to this adjustment, Mr. Effron's calculation does not reflect the use of test year-end number of customers. He has computed a simple average of total distribution revenues (excluding Princeton Paper) actually experienced during the 1999 and 2000 calendar years, in essence a revenue averaging method, crossing over two separate test years.

Fitchburg Reply, p. 10. While Fitchburg has disagreed with Mr. Effron's position that revenue should be adjusted to reflect the end of year number of customers, it did not contest his quantification of the necessary adjustment anywhere on the record, either through rebuttal or cross-examination. Therefore, the Department should disregard the Company's assertion that Mr. Effron's calculation does not reflect the use of test year-end number of customers. This assertion is completely unsupported on the record. Mr. Effron's testimony that his adjustment is consistent with the use of an end of year rate base, which reflects the investment necessary to serve the end of year number of customers (Exh. AG-2, pp. 3-4), was not challenged. The use of one-half year of revenue growth is a commonly used convention to reflect the difference between revenue produced by year-end and revenue produced by test year average customers, based on the premise that the difference between the year-end and average customers approximates one-half the difference between the beginning and year-end number of customers, which would be equal to one year of the revenue incremental to that already inncluded in the test-year that new customers will contribute o the system simply due to an annualization of their sales volumes.

D. CASH WORKING CAPITAL

The Attorney General proposes to use a 6.8 day lag to determine the cash working capital assocaited with external transmission expense. Fitchburg, in its reply brief, describes to the assignment of a 6.8 day lag to external transmission expense as an example of "selective adjustments to reduce the net lag that where favorable to the Attorney General should not be arbitrarily accepted when they are in dispute and unsupported by record evidence." Fitchburg Reply, p. 11. In fact, it is Fitchburg that has arbitrarily assigned a lag of 45 days to external transmission expense without any record evidence to support such a lag. Mr. Collin acknowledged that the Company itself had not applied the 45-day lag to all expenses without exception. Tr. 1, pp. 102-103. The record in this case establishes that external transmission expense is similar to purchased power expense with regard to cash working capital requirements. Exh. FGE-2, p. 18, ll. 12-19 and Exh. FGE-2, p. 19, l. 18-p. 20, l. 20. Fitchburg has not claimed that the lag for external transmission expense is different from the lag for purchased power. Therefore, if external transmission expense is included in the cash working capital allowance, the lag assigned to this expense should be 6.8 days, the same as the lag assigned to purchased power expense.

E. BAD DEBT ADJUSTMENT

The Attorney General in his brief recommends that the Department follow its well-established precedent to determine the Company's pro forma bad debt expense by using the most recent three years of of net write-offs. The Company's use of a three-year average net write-off ratio consisting of the years 1997-1999 is completely inappropriate for the purpose of establishing bad debt expense to include in the pro forma cost of service. The net write-off ratio for 1997 is stale, anomalous, and unsupported. First, 1997 falls outside the three latest known years of data, which consist of the years 1998-2000. Second, even a brief glance at the experience for the years 1997-2000 shows that 1997 is an outlier, with $401,880 of net write-offs, with the other years all being in the range of $273,216 - $292,805. FGE-2, Sch. MHC Supp-10, 1999 and 2000. Third, despite Fitchburg claims to the contrary, there is no support for the $401,880 of net write-offs in 1997. In its reply brief, Fitchburg states that "supporting information for the 1997 net write-off ratio appears on 1999 Sch. MHG Supp. 10." Fitchburg Reply, p. 14. Reference to the cited schedule indicates $401,880 of net write-offs in 1997, but nothing in the way of support of this figure. Exh. AG-IR-1-69, also cited by the Company on page 14 of its reply brief contains absolutely no information for 1997. The statement by Fitchburg that it "has presented ample detail on the 1997 ratio" (Id.) is not only without citation, it is without foundation. There is no support for the 1997 write-offs or even any explanation of why the write-offs for that year are so out of line with the other years. Any three-year average used to develop the net write-off ratio should exclude 1997.

F. RATE CASE EXPENSE

The Company states in its reply brief "the Department requires that a normalization period for rate case expense be derived based on the average of the intervals between the filing dates of a company's last four rate cases." Fitchburg Reply, p. 15. This illustrates the conservative nature of the Attorney General's use of a five-year amortization period. If Mr. Effron derived a normalization period for rate case expense based on the average of the intervals between the filing dates of a company's last four rate cases, the normalization period would be significantly longer than five years.

The Company's assertion that "Here, there is absolutely no risk of overcollection of rate case expense" (*Id.*) is erroneous. There is the same risk of overcollection here that there is in a traditional rate case. That is, if rate case expense is amortized over three years and that amortization expense is included in the cost of service on which rates are based, Fitchburg will over-collect rate case expense if the next rate case is not for another sixteen years. The rates being charged by Fitchburg will continue to reflect a recovery of rate case expense after that expense has been completely recovered, absent a downward rate adjustment after three years. The Company's "anticipation" about what might or might not happen in any performance based ratemaking docket is completely speculative and should be disregarded.

G. INFLATION ALLOWANCE

The Attorney General proposes to exclude outside services expense from the Company's inflation adjustment since that cost has not been effected by inflation. Fitchburg argues that outside services should be included in the expenses subject to the inflation allowance, claiming that outside services are subject to inflation, just like other expenses that are not specifically adjusted. However in its brief and in its reply brief, Fitchburg fails to answer one basic question: If outside services are subject to inflation, and if there was inflation from 1999 to 2000, then how is it that distribution related outside services expense decreased from $2.6 million in 1999 to $2.2 million in 2000, a decrease of 15%? More importantly, if the purpose of the inflation adjustment is to "reflect the likely cost of providing the same level of service in the future as was provided in the test year," how is that end served by increasing an expense for inflation, when it is known for a fact that that expense has decreased materially since the test year? Fitchburg

Reply, p. 17.

The Attorney General agrees that the variation of the level of outside services expense from year-to-year is not itself a reason for excluding the test year level of these expenses from the inflation adjustment. To reflect an inflationary increase for an expense that we know has decreased would distort the determination of the pro forma cost of service. However, the fact that outside service expenses have actually decreased since the test year is a reason for excluding the test year level of these expenses from the inflation adjustment. It must be emphasized that the Attorney General is not proposing to reflect the actual decrease in outside services expense that has actually taken place, although such proposal is certainly defensible. Rather, the Attorney General is simply proposing not to reflect a pro forma increase for an expense that has actually decreased. The Department should accept this reasonable, conservative proposal and exclude outside services expense from the base of expenses included in the inflation allowance.

H. DEPRECIATION

The Attorney General proposes that the Department wait until it has better record evidence before it orders a change in the Company's depreciation accrual rates. The Company's statement that "The Attorney General, for the first time on brief, has dramatically reversed and undercut his own expert witness who adopted the higher depreciation rates proposed by Fitchburg and derived from the 1998 study" is a plain mischaracterization. Fitchburg Reply, p. 19. However, as Mr. Effron made clear, the higher depreciation rates should be incorporated into the determination of the cost of service if, and only if, Fitchburg were to unconditionally implement the new depreciation rates at the conclusion of this case. AG-2, pp.2-3, p.3, pp.14-15; Tr. 1, pp. 9-10. Fitchburg stated in no uncertain terms that it has no intention of implementing the new depreciation rates at the conclusion of this case. Exh. Fitchburg 2, p. 46;

Fitchburg Brief, p. 35.

The problem with the Company's position is that if the Company's rates are set to recover the effect of the higher depreciation rates and those higher depreciation rates are not implemented, then the Company's rates will be set to recover an expense that it is not actually incurring, and its over-earnings, which this proceeding should resolve, are perpetuated. Unless the new depreciation rates will be implemented with complete certainty at the conclusion of this case, the effect of the new depreciation rates should not be included in the determination of Fitchburg's revenue requirements. Accordingly, the new depreciation accrual rates being proposed by the Company should not be incorporated into the determination of revenue requirements at this time.

The Company's defense of its proposal to implement the new depreciation rates is unconvincing, at best, and should be rejected by the Department. As the Attorney General, pointed out in his initial brief, there was no opportunity to conduct any discovery on the Company's proposal. In responses to Attorney General information requests, the Company presented calculations showing the pro forma depreciation expense using a depreciation accrual rate of 4.00%. Tr. 1, p. 138. This was not modified until Fitchburg Witness Collin submitted his supplemental testimony, Exh. Fitchburg-2. Id. As the Company well knows, this was after the close of discovery on cost of service issues, and the Attorney General had no opportunity to conduct discovery on Exh. Fitchburg-2, the Company's statements in its reply brief to the contrary notwithstanding.

Nor has the Company satisfactorily resolved the obvious problems with its depreciation study. For example, in its reply brief, the Company defends its proposed depreciation accrual rate for Account 373 – Street Lighting and Signal Systems, by arguing that it is perfectly reasonable for this account to be depreciated down to a net book value below zero, in order to allow for future cost of removal. Fitchburg Reply, pp. 20-21. However, there is no evidence in this case that the potential cost of removal for this account is of such a magnitude that the appropriate depreciation accrual rate for the account produces such a result. This is an excellent example of why the proposed depreciation accrual rates should not be implemented without further investigation.

Fitchburg also claims that the Attorney General has miscalculated the pro forma depreciation expense using present depreciation accrual rates. Fitchburg Reply, p. 20. First, Mr. Effron presented his calculation of the pro forma depreciation expense using present depreciation accrual rates in his Supplemental Testimony, Exh. AG-2, at Exh. DJE-3, Schedule 3, p. 3. Mr. Collin did not address this calculation in his Supplemental Testimony, Exh. Fitchburg-2, nor did the Company cross-examine Mr. Effron on this matter. Therefore, Mr. Effron's calculation of the pro forma depreciation expense using present depreciation accrual rates is uncontested on the record, and the Department should disregard the Company's comments, which are in effect new, unsworn testimony, on this matter in its reply brief.

Fitchburg claims that Mr. Effron used the wrong starting point as the actual test year depreciation expense in his calculation of pro forma depreciation expense. (The calculation of the annualization adjustment to reflect depreciation on end of year plant in service is not in dispute.) In particular, the Company states that Mr. Effron used $1,468,000 as the actual test year depreciation expense, whereas he should have used $1,669,206, which is the amount shown in Exh. AG-IR-4-13. Fitchburg Reply, p. 20. Referring to Exh. AG-IR-4-13, the source for the $1,669,206 is indicated as the 1999 FERC Form 1, p. 336, l. 11. Reference to the 1999 FERC Form 1 shows that $1,669,206 is the total 1999 depreciation expense on all plant in service, including transmission plant. Transmission plant is excluded from the distribution cost of service. *See e.g.*, Exh. Fitchburg-2, Sch. MHC Supp-17 and Sch. MHC Supp-16 (no transmission plant is included in rate base and no depreciation on transmission plant is included in expenses). Therefore, the depreciation expense on transmission plant should not be included in actual test year depreciation expense on distribution plant. When the $201,000 of depreciation expense on transmission plant is removed from the 1999 total depreciation expense of $1,669,206, the result is $1,468,000, the actual 1999 depreciation expense used by Mr. Effron as his starting point. The $201,000 difference cited by the Company on page 20 of its Reply Brief is due to the Company's inclusion of depreciation on transmission plant in its starting point. This is erroneous. The Department should disregard the Company's calculation of pro forma test year depreciation expense under present depreciation accrual rates on page 20 of its Reply Brief. The correct number is $1,579,000, as presented by Mr. Effron on Exh. AG-2, at Exh. DJE-3, Schedule 3, p. 3.

I. ISSUES FROM D.T.E. 99-110

As stated in the Attorney General's Initial Brief, the Company has identified three related issues from D.T.E. 99-110: FAS 109, divestiture related administrative and general transaction costs, and supply management administrative costs. It is the Company's position that the Department's resolution of these issues in D.T.E. 99-110 will affect the determination of the distribution cost of service in this case.

In its Reply Brief, Fitchburg states "the record indicates that the FAS 109 regulatory asset related to the generation function was not included in the calculation of the amount of accumulated deferred income taxes assigned to the distribution function in this proceeding." Fitchburg Reply, p. 22. However, the citations to support this assertion are conclusory and circular. The Company has not demonstrated that the FAS 109 regulatory asset that it claims is generation related has been excluded from the distribution rate base in this case. The reason for this is simple. The FAS 109 regulatory asset that the Company claimed to be generation related in DTE 99-110 has not been excluded from the distribution rate base in this case. The Attorney General's initial brief established that Fitchburg has not treated any of the FAS 109 regulatory asset as being attributable to generation in this case. The Company has offered nothing to refute the analysis in the Attorney General's Initial Brief. Accordingly, if the Department accepts the Attorney General position on FAS 109 in D.T.E. 99-110, no adjustment is necessary in this case.

The Attorney General does not dispute the Company's contention that if the Department finds in DTE 99-110 that divestiture related administrative costs and supply management administrative costs are distribution expenses, Fitchburg should be permitted the opportunity to justify their inclusion in its cost of service as a distribution expense. However, in this case, the distribution revenue requirement is being determined prospectively. The expenses cited by the Company were incurred in the years 1997-1999. Fitchburg has provided no evidence that would establish that these costs are normal, ongoing, recurring expenses that will be incurred in the rate effective period. Absent such a demonstration, the Company should not be allowed to include such expenses in the distribution cost of service. Tr. 1, pp. 28-29. As the record stands, it is unnecessary to adjust rate year expenses for divestiture related administrative costs and supply management administrative costs.

J. COST OF COMMON EQUITY

1. INTRODUCTION

The Attorney General on brief made arguments and recommendations to correct the Company's proposed applications of the financial models used to determine its cost of common equity. AG Brief, pp. 29-41. The Company argues at length in its reply brief that the Department should give no weight to these arguments since the Attorney General did not supply a witness on the cost of capital. Fitchburg Reply, pp. 25-27. The fact that the Attorney General did not sponsor a witness should not prevent the Department from making the necessary corrections to the Company's proposed calculations based on record evidence to fix errors and inconsistencies in the applications to determine its cost of common equity. However, it should be noted that Mr. Effron based his recommendations for the Company's revenue requirement on the cost of common equity of 10.58%, which is what the Company requested, and the Department approved as an allowed return on common equity in the determination of carrying charges on the net balance of generation investment in D.T.E. 97-115.

2. THE COMPANY'S ARGUMENTS REGARDING MR. HADAWAY'S COMPARISON GROUP INDICATE A FAILURE TO UNDERSTAND THE CONCEPT OF INVESTMENT RISK AND ITS COMPONENTS

The Attorney General, on brief, argued that the Company's cost of equity witness, Mr. Hadaway failed to recognize the difference in investment risk between the companies in the comparison group that he used for his cost of equity analyses and that of Fitchburg's electric distribution business. AG Brief, pp. 30-31. The result of this failure was that his recommended cost of common equity range had no relation to and grossly overstated the cost of equity for the Company in this case.

The Company argues in response that Mr. Hadaway's choice of utility companies for his comparison group results in a conservative cost of equity estimate since this group has a lower financial risk profile than that of Fitchburg's electric distribution company. *Id*. Furthermore, the Company argues that the Department should consider the risks associated with the generation - related transition charge recovery when determining the cost of equity for the distribution business. *Id*. However, as will be discussed *infra*, both of these arguments are incorrect and should be disregarded by the Department.

The Company's reply brief reflects a misunderstanding of the concepts of investment risk and its components, financial risk and business risk. *NYNEX*, D.P.U. 94-50, pp. 450-451 (1995);

Western Massachusetts Electric Company, D.P.U. 89-255, pp. 83-84 (1990). Investors face two types of risks when making their investments in common stock: (1) financial risk or the risk associated with the manner in which the firm is financed with debt; and (2) business risk which is all risk other than financial risk including operating risk, managerial risk, and regulatory risk. *Id.* It is the combination of these two types of risk that investors face when making their investment decisions.

In this proceeding, the Company has included an inadequate financial risk analysis and no business risk analysis. In fact, the Company's brief fails to recognize the difference between the two types of risk when it cites Mr. Hadaway's financial risk analysis for its comparison of business risks. Fitchburg Reply Brief, p. 27. Although Mr. Hadaway started to perform a financial risk analysis of his comparison group by reviewing the equity ratio, and relative size of the utilities, he failed to consider any of the other indicators of financial risk including the cash flow and interest coverage ratios.[5] Tr. 2, p. 173. Mr. Hadaway's analysis represents an incomplete financial risk analysis with absolutely no business risk analysis.[6] Certainly, it provides no basis for a finding that the Company's financial risk, much less its total investment risk is higher than that of the companies in the comparison group.

The Company, in its reply brief, continues to argue that the costs and risks associated

---

[5] Equally, his "analysis" of the bond ratings of his comparison group and the comparison to Fitchburg's must fail since he did no such analysis.

[6] The witness was asked:

> Q. Did you do an analysis of those statistics for Fitchburg Gas and Electric?
>
> A. I did not do a specific analysis except to the extent that I looked at the equity ratio that I mentioned earlier, being in the 41 percent range. The other statistics are ones that I commonly work with each day, and in fact I am working with in other cases right now. So I did not do a specific analysis. Tr. 2, p. 173.

with the generation-related transition charge should be considered in determining the cost of equity for its distribution business. Fitchburg Reply, p. 26. The fact is, however, that the Company asked for and received the return on generation assets that it required in the Restructuring case, including the bonus of an incentive rate of return on asset sales. D.T.E. 97-115, pp. 70-71. The Company cannot now claim that it is not compensated for its transition costs including a return on those assets, when it is actually receiving more than what the Company itself had requested as a fair return.

3. THE COMPANY'S DISCOUNTED CASH FLOW GROWTH RATE ESTIMATES ARE BIASED UPWARDS

The Attorney General showed in his brief that Mr. Hadaway's Discounted Cash Flow ("DCF") growth rate estimates for his constant and his non-constant growth rate analyses were biased upward, resulting in cost of equity estimates that were proportionately too high. AG Brief, pp. 32-36. First, regarding the constant growth rate DCF analysis, the Company argues in its reply brief that Mr. Hadaway's 6.36 percent growth based short-term forecasts is an appropriate estimate of investors' long-run growth rate expectation for a utility stock. Fitchburg Reply, pp. 28-29. However, Mr. Hadaway's 6.36 percent growth rate which was derived from short-term earnings per share growth rate forecasts cannot represent long run expectations, since it is so out of line with historical growth rates. Exh. AG-6-15. The ten-year historical growth rates included the most recently available for the comparison group companies as reported by Value Line are as follows:

	Dividends Per Share	Earnings Per Share	Book Value Per Share
Ameren	2.5	-0.5	2.0
Cleco	3.0	3.5	3.5
DPL	4.0	2.5	3.5
DQE	6.0	6.5	4.5
DTE	2.0	1.5	5.0
Eastern Energy	-3.5	1.0	2.5
FPL Group	-1.0	2.0	1.5
IDACORP	0.5	3.5	1.5
KCPL	3.0	0.5	0.5
NSTAR	0.5	3.5	2.5
Pincale West	-6.0	2.5	1.5
Potomac Electric	2.0	-2.0	2.0
Puget Energy	0.5	-2.5	0.0
UIL Holdings	2.0	-6.0	-1.0
SUM	15.5	16.0	29.5
Average	1.1	1.1	2.1

See Exh. AG-6-13 and AG-6-14.

Clearly, these historical rates refute the Company's use of an unadjusted short-term growth rate of 6.36 percent as a proxy for the long-run growth rate out until infinity. Second, the Company argues, without record support that these historical growth rates have been biased down by industry restructuring and divestitures. Fitchburg Reply, pp. 28-29. However, any effects that might of occurred, associated with restructuring and divestiture should to a great extent have been offset by the benefits of mergers and acquisitions and the sales of power into the unregulated generation market. *Id*. One could not properly adjust for one without the other.

Finally, the Company argues against the use of the most recent ten-year growth in the historical Gross Domestic Product as the basis for the final period long-run growth rate in Mr. Hadaway' non-constant growth rate DCF model, claiming that the Attorney General "chose" an unrepresentative period to determine such a rate. Fitchburg Reply, p. 28. In fact, it was the Company's witness that chose the ten-year period in his prefiled testimony as the period to review and to be representative of the markets and financial indicators in performing his cost of equity analysis. Exh. FGE-SCH-1. Furthermore, the growth rates and inflation during that ten-year period are certainly more in line with the expectations of the future than those rates during the other periods of hyper-inflation that the Company set forth .[7]

4. CONCLUSION

For all of the reasons set forth here and in the Attorney General's Initial Brief, the Department should reject Mr. Hadaway's cost of equity recommendations and find that the appropriate cost of equity for Fitchburg's electric distribution business is 9.9 percent.

[7] The Company attempts to support its argument by providing extra record information in its reply brief at page 28, footnote 13. Needless to say that the Department cannot give any weight to this information in its analysis and findings.

IV. CONCLUSION

Wherefore, for all of the foregoing reasons, the Attorney General urges the Department to find that Fitchburg's current rates are unreasonable and establish rates and charges consistent with the positions taken in the Attorney General's Initial and Reply Briefs by decreasing base rates across the board on an equal percent basis.

Respectfully submitted,

THOMAS F. REILLY
ATTORNEY GENERAL

By: Alexander Cochis
Joseph W. Rogers
Assistant Attorneys General
Utilities Division
Public Protection Bureau
200 Portland Street
Boston, MA 02114
(617) 727-2200

Dated: July 17, 2001